AT&T

James W. Cicconi
General Counsel and
Executive Vice President
Law & Government Affairs

Suite 1000
1120 20th St. NW
Washington, DC 20036
202 457-2233
FAX 202 457-2244

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Honorable Michael Powell
Chairman
Federal Communications Commission
445 12th Street, S.W.
Washington, DC 20544

Dear Chairman Powell:

Verizon's Executive Vice President and General Counsel quite correctly acknowledges the fine work done by the Commission, its staff, and its lawyers to secure the Commission's Supreme Court victory affirming the TELRIC pricing rules and rejecting the many challenges to those rules brought by Verizon and the other Regional Bell Operating Companies ("Bells"). *See* July 16, 2002 Letter from William B. Barr to the Honorable Michael Powell ("*Verizon Letter*").

Verizon urges the Commission, however, to use the Supreme Court's unqualified endorsement of the Commission's TELRIC rules as an opportunity to abandon them in all but name. As we explain in the attached analysis, although Verizon couches its proposals as "additional clarification" and a single "modification," each proposed change would directly violate core TELRIC principles, as state commissions, courts and the Commission have held. Indeed, one of Verizon's "key issues" for "clarification"—its objection to the forward-looking "instantaneous replacement" of assets—was Verizon's *principal* attack on TELRIC before the Supreme Court. It is disappointing that Verizon has chosen to continue its meritless war on TELRIC, rather than to accept and abide by the Supreme Court's ruling.

Apart from Verizon's specific proposals, however, Mr. Barr's letter holds promise in one respect. For the first time, a Bell company has conceded that the Commission's UNE pricing rules could "ensure the appropriate incentives for efficient investment, entry, and other competitive decisions by *all* providers." *Verizon Letter* at 1 (emphasis added). Verizon suggests that its proposed refinements to the TELRIC rules would be necessary to achieve that result. Although that is incorrect, we do agree that the TELRIC pricing methodology is flexible enough to accommodate any concerns related to risk and investment incentives. AT&T has been saying exactly that for the entire time that Verizon and the other Bells have been challenging the validity of the

TELRIC standard. Notably, Verizon's long-overdue but welcome recognition that TELRIC is sufficiently flexible to accommodate Bell investment has far-reaching implications in a host of crucial Commission proceedings.

Verizon and the other Bells have conjured a broadband crisis to support a series of radical and patently anticompetitive proposals which, taken together, would dismantle nearly the entire regulatory framework that makes competition possible. In the *Triennial Review* proceeding, the Bells urge the Commission to exempt both existing "broadband" and "new" facilities from the Act's unbundling requirements—and, indeed, to "delist" *all* UNEs, except perhaps voice-grade analog loops. In the *ILEC Broadband Dominance* proceeding, the Bells urge the Commission to declare them "nondominant" in the provision of *all* "broadband" services, notwithstanding that, for many customers, the Bells are monopoly broadband providers. And in the *Wireline Broadband* proceeding, the Bells urge the Commission to exempt their "broadband" services and facilities from *all* Title II regulation. AT&T and others have already explained why the Commission could not lawfully endorse the Bells' anticompetitive proposals in the *Triennial Review*, *ILEC Broadband Dominance*, and *Wireline Broadband* proceedings and why those proposals would have catastrophic consequences for consumers and competition.

In each proceeding, the Bells have trundled out the rallying cry of investment incentives. Allowing competitors to "free ride" on the Bells' investments, they complain, will destroy incentives to invest in new facilities and services. The current cry from Verizon is especially ironic, because Verizon, which is now reported to be the fourth largest IXC in the country, is apparently leasing and reselling wholesale capacity from facilities-based carriers like AT&T rather than investing in its own facilities (according to industry analyst Dan Reingold in a report issued on July 25, 2002). In any event, the Act and the Commission's TELRIC rules require competitive LECs to pay cost-based rates -- that include a return on investment -- for the network elements that they lease, foreclosing any claim of free-riding. And Verizon now effectively concedes in its letter what the record in those proceedings already overwhelmingly establishes: proper implementation and enforcement of the Commission's TELRIC pricing rules, not wholesale dismantling of the statutory market-opening requirements and consumer protections, is the way to ensure optimum levels of investment by all market participants.

Thus, even if concern for the Bells' investment incentives could, as a matter of theory, trump both established law and the public interest, there is no reason why unbundling under the TELRIC standard, properly applied, should lead to underinvestment and therefore no real-world basis for barreling ahead with the Bells' UNE and broadband agendas. Verizon now, for the first time, has confirmed what the Commission has recognized since 1996. The existing TELRIC rules provide Verizon and the other Bells every opportunity in state proceedings to establish the UNE rates that are necessary to reflect the particular costs and risks that they face and thereby to maintain appropriate investment incentives.[1] And I respectfully urge that the appropriate course for the Commission in this increasingly fragile competitive environment is to reject the Bells' cries for radical reform that will benefit only them and instead – by reaffirming that the Bells must make a full range of UNEs available and by flatly rejecting the Bells' unlawful *Wireline Broadband* and *ILEC Broadband Dominance* proposals – to make it unambiguously clear to consumers, competitors and financial markets that the Commission stands behind the Act's core market-opening requirements and goals.

Although I have attached a point-by-point rebuttal of Mr. Barr's assertions, I do not believe, nor does the Commission's settled history suggest, that the Commission is the appropriate regulatory agency initially to perform, input-by-input, the extensive cost analysis necessary for a proper determination of TELRIC rates. Since the Commission first adopted the overall TELRIC framework in 1996, state public service commissions have been engaged in that analysis to apply the framework within a particular locale, and have finally started to achieve meaningful success, using the Commission's existing rules. Consumers across the Nation are increasingly enjoying the fruits of this work. Verizon's resort should be to the state commissions to determine whether any change in UNE rates is needed, under the existing TELRIC rules, to better reflect the costs and risks it faces. I would welcome an opportunity to discuss with you ways in which the Commission could facilitate state pricing determinations addressing the investment concerns raised in the Commission's *Triennial Review*, *ILEC Broadband Dominance*, and *Wireline Broadband* proceedings, and promptly conclude these proceedings in a manner that fosters competition and restores certainty to the marketplace.

Very truly yours,

James W. Cicconi

James W. Cicconi

Att.

Cc: Commissioner Abernathy
Commissioner Copps
Commissioner Martin

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[1] *See Verizon Communications*, 122 S. Ct. at 1677 ("TELRIC itself prescribes no fixed percentage rate as risk-adjusted capital costs and recognizes no particular useful life as a basis for calculating depreciation costs" and, therefore, may be "adjusted upward if the incumbents demonstrate the need"); *see also id.* at 1678 (because "TELRIC rates are calculated on the basis of individual elements . . . . TELRIC rates leave plenty of room for differences in the appropriate depreciation rates and risk-adjusted capital costs depending on the nature and technology of the specific elements to be prices").

Attachment

The following responds to Verizon's specific TELRIC proposals in its July 16, 2002 Letter from William B. Barr to the Honorable Michael Powell ("*Verizon Letter*"). Each of Verizon's proposals is little more than a reprise of arguments that Verizon has advanced repeatedly (and almost always unsuccessfully) in the course of Verizon's six-year legal campaign against TELRIC.

Cost of Capital. Verizon's arguments for changing the Commission's cost of capital standard (Verizon Letter at 2) are a parade of misstatements. First, the notion that the Commission or the Supreme Court intended to allow only upward (but not downward) departures from the Commission's default value of 11.25 percent is a Verizon invention. In the *Local Competition Order*, the Commission directed state commissions to "adjust the cost of capital if a party demonstrates . . . that either a higher *or lower* level of cost of capital is warranted." *Id.* (emphasis added). Nothing in the Supreme Court's discussion of the issue suggests that the Court intended to vacate the second half of the Commission's directive. To the contrary, the Court prefaced its general discussion of the TELRIC standard by emphasizing the Commission's broad discretion in choosing cost standards, and introduced the Court's specific discussion of the "risk-adjusted costs of capital" by noting that "competition in fact has been slow to materialize in local-exchange retail markets." Exercising their discretion under the *Order*, seven of the eight state commissions that have made a cost of capital finding in a Verizon UNE case have found that the forward-looking risk of Verizon's UNE business warrants a cost of capital well below 11.25 percent— in the judgment of some commissions, as low as 8.5 percent.

Second, Verizon's assertion that its UNE business realistically anticipates a much greater competitive threat from facilities based competition today than six years ago is equally meritless. Even Verizon's cost of capital witness has conceded in recent UNE cases that facilities-based CLEC entry is unlikely to make significant inroads into Verizon's local business for the foreseeable future. With the near collapse of the CLEC sector, Verizon's self-portrayal as a beleaguered competitor no longer passes even the laugh test.

In any event, the Commission's rules do nothing more than impose on incumbent LECs the burden of "demonstrating with specificity" the business risks that "they face" in providing unbundled network elements. *Local Competition Order* ¶ 702. Verizon's proposed standard, which would require state commissions to impute to Verizon the fictional business risks that Verizon *might face* only if (contrary to fact) the local market were fully competitive, is obviously at odds with this language. Moreover, the required factual inquiry, and the Commission's allocation of the burden of proof for resolving any disputed facts, would be pointless if the Commission had meant for state commissions simply to *presume* (falsely) the existence of intense competition.

Finally, Verizon's allusion to "uncollectibles" is an empty makeweight. UNE prices as calculated in state proceedings and by commonly-used TELRIC cost models include an allowance for uncollectible revenue. If Verizon believes that the recent bankruptcies of WorldCom and other CLECs warrant a higher allowance than previously approved, Verizon is free to ask state regulators to reopen its UNE prices so that the allowance for uncollectibles may be increased going forward. The evidence is likely to show, however, that any rise in the percentage of uncollectibles has been more than offset by unanticipated trends in other costs. These trends include the decline in the cost of capital since 1997, the major recent declines in the discounted price of switching equipment, and the increasing automation of currently available loop and switching technology. Until these issues have been raised and resolved at the state level, Commission intervention is premature. There is certainly no justification for the Commission to prejudge the issue by arbitrarily inflating the default cost of capital.

Depreciation. Verizon's requested clarification for depreciation lives is equally unjustified. As the Supreme Court has noted, the Commission's standards provide sufficient flexibility for states to make an appropriate adjustment in depreciation lives if the record in a UNE rate case demonstrates that forward-looking changes in competition or technology warrant shorter (or longer) lives. Verizon, however, has offered no reason why the Commission should prejudge the issue at this time, let alone dictate adoption of GAAP accounting lives or preclude further use of the Commission's own forward-looking prescribed economic lives.

Verizon simply misrepresents the Commission-prescribed depreciation lives. In fact, those lives reflect a rigorous application of forward-looking principles by the Commission and its staff, including a "detailed analysis of each carrier's most recent retirement patterns, the carriers' plans, and the current technological developments and trends." The Commission has reviewed the prescribed life ranges repeatedly since 1994. In 1999, the Commission reaffirmed that its lives "represent the best forward-looking estimates of depreciation lives" and are therefore appropriate for use by state commissions "for determining the appropriate depreciation factors for use in establishing high cost support and interconnection and UNE prices." The majority of state commissions to consider the issue have accepted the Commission's depreciation lives in UNE cases as the best evidence of Verizon's forward-looking lives.

Moreover, the Commission's existing rules offer Verizon several vehicles for seeking review of the Commission-prescribed depreciation lives directly from the Commission itself. Verizon is free to ask the Commission to institute a new three-way depreciation proceeding for any state where Verizon believes that the currently prescribed lives are no longer realistic. Procedures established by the Commission in December 1999 also entitle Verizon to gain approval for additional depreciation charges by showing that additional charges or write-offs are warranted, deducting the additional amounts from the carrier's regulatory as well as financial accounts, and agreeing to additional safeguards designed to ensure that the amounts will not be charged to ratepayers through other mechanisms. Verizon has sought relief through none of these mechanisms. In short, Verizon wants to gain shorter depreciation lives without submitting to Commission and public scrutiny the evidence needed to justify them.

Verizon has also failed to justify adoption of a generic Commission command that states use financial accounting lives (also known as "GAAP lives") in setting UNE prices. GAAP lives are significantly shorter than the lives prescribed by the FCC, and are an unsuitable proxy for economic lives. Financial accounting lives are biased towards the low (shorter) side because they are driven by corporate objectives, including the objective of protecting shareholders, and by the GAAP principle of conservatism, which encourages the accountant to err on the side of overstating costs for financial reporting when there is uncertainty about their precise level. In the wake of recent accounting scandals, this bias toward conservatism is likely to be stronger than ever. Under the 1996 Act, however, the objectives of the Commission and state regulators are to protect consumers and jump-start competitive entry—objectives that require error, if any, in the opposite direction. Unsurprisingly, the Commission has properly declined to accept GAAP lives for regulatory purposes, and state commissions have generally done likewise in UNE cases.

Replacement Cost. Verizon's letter saves its most basic assault on TELRIC for last. The issue is whether TELRIC is a long-run measure of cost (as the Commission and the Supreme Court have held), or whether it should be replaced with a *short-term* cost standard such as 3-5 years (*Verizon Letter* at 4-5). A long-run time horizon—also known as the "reconstructed network" assumption—is a fundamental element of TELRIC, and properly so.

Since 1996, the FCC's rules have defined TELRIC as the costs of a "reconstructed" network built with the "most efficient telecommunications technology currently available." This definition is the only one consistent with a long run cost standard. As the Commission explained in its *Local Competition Order*, in the long run "all of a firm's costs become variable or avoidable," for "all of a firm's present contracts will have run out, its present plant and equipment will have been worn out or rendered obsolete and will therefore need replacement."

Jettisoning the long run cost standard in favor of the short run standard proposed by Verizon would clearly violate the policies of the 1996 Act. As the Supreme Court held in its May decision, the 1996 Act called for "ratemaking different from any historical practice, to achieve the entirely new objective of uprooting the monopolies that traditional rate-based methods had perpetuated." Put simply, the Commission's obligation is to "give aspiring competitors every possible incentive to enter local retail telephone markets, short of confiscating the incumbents' property." UNE pricing must serve as a surrogate for effective competition where competition has long been absent. To base prices on the costs of the incumbents' existing, embedded, networks, with forward-looking adjustments limited to those that the incumbents expect to make in some arbitrary short-run period, would shelter Verizon and its peers from the competitive forces of "creative destruction" that Verizon professes to embrace. It would be self-defeating to set prices that allow incumbents to recover the costs of the gold plating, excess capacity, obsolete technology and other inefficiencies that are the legacy of decades of operation as a regulated monopoly.

Verizon's suggestion that the costing time horizon should be limited to 3-5 years because the *future* path of technology can be foreseen only for 3-5 years is a red herring. The issue is not how soon Verizon will implement future technology that is still undeveloped or commercially unavailable. The issue is whether UNE prices should reflect the excess costs of technology that is *now* obsolete as a result of better or cheaper technology that is *already* commercially available.

Technology Mix. Verizon's request for "clarification" of the "assumed technology mix" is essentially a reprise of the long run vs. short run cost issue. The long run standard of a reconstructed network asks the cost analyst to determine what kinds of assets and technology a firm would install if building the network from scratch.

If an efficient new entrant today would equip its entire network with a particular technology, it is irrelevant how much of that technology an incumbent now has in place (an embedded cost issue) or plans to install in the next few years (a short run cost issue). For example, it is irrelevant whether the switching investment planned by an incumbent in the next few years is limited to "growth" or add-on equipment. If a new entrant today would buy all-new switching equipment, the incumbent's embedded equipment mix and short-run purchasing plans are beside the point. And it is irrelevant that the advent of new technology does not generally lead to the instantaneous replacement of older equipment. "Instantaneous replacement" is merely a proxy for what actually happens in competitive markets: the instantaneous downward *revaluation* of the economic value of existing assets in response to the rollout of newer, more efficient technology. Effective competition quickly reduces the economic value of older equipment by an amount large enough to offset the operating efficiencies of the newer equipment. It is precisely for this reason that Dr. Alfred Kahn, an economist repeatedly invoked (and frequently hired) by Verizon, has noted that cost of service of new and old equipment should be "exactly equal" if "the economic value" of the old equipment is "correctly stated on the books."[2]

Fill Factors. Verizon's proposal that "existing fill factors in incumbent networks" serve as the definitive basis for TELRIC fill factors is a naked plea for recovery of embedded costs. State commissions have repeatedly found that efficient forward-looking fill factors in Verizon's territory are higher than its embedded fill factors. As a District Court noted in upholding one of those decisions two years ago, the "current state of [Verizon's] network is irrelevant for purposes of a long-run cost analysis."

The supposed incentives of "price cap regulation" and "competitive pressures" do not warrant a contrary result. Much of Verizon's embedded outside plant was built before the advent of price cap regulation. And the threat of competitive entry gives Verizon an incentive not to build an efficiently sized plant, but to create an entry barrier by building an oversized plant and persuading regulators to force competitors to pay for as a large share of it as possible through inflated UNE prices.

Verizon's claim that competitive diversions to "wireless and cable companies" warrant the adoption of regulatory fill factors that are *lower* than embedded levels is absurd. No competitive market would allow an incumbent firm to respond to inroads from new competitors by *raising* its prices or forcing its customers to pay for *more* unused capacity. Moreover, Verizon's claim is a directly at odds with its position in recent UNE cases at the state level, where Verizon witnesses have testified that demand for Verizon-supplied loops is expected to

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[2] Verizon's claim that GR-303 technology is not yet commercially available for unbundling underscores the anticompetitive implications of Verizon's proposed costing approach. GR-303 has, in fact, been available for years, currently serves many millions of lines, and is extremely popular, precisely because it is cost effective *today*. The fact that incumbent LECs have sunk existing investments in predecessor technologies does not make GR-303 "currently unavailable."

grow, not shrink. Whether demand grows or shrinks, the only constant in Verizon's litigation posture is that users of UNEs should pay more.

Non-Recurring Costs. Non-recurring costs are a final area where Verizon would hold TELRIC hostage to the incumbent LECs' embedded operating practices—often manual, obsolete and costly—either in their existing form or with the minor improvements that incumbent LECs assertedly plan to make in the short run. In reality, as many state commissions have found, nonrecurring services can be provided far more economically through automated methods that are already available on the market. Basing nonrecurring charges on the incumbent LECs' embedded practices eliminates any incentive for ILECs to reduce the costs of the services that incumbent LECs must provide to their competitors. Moreover, Verizon's position suffers from a serious internal inconsistency. In recent UNE cases (*e.g.*, the one concluded last year in New York), Verizon has simultaneously sought to recover recurring costs that reflect the added capital costs of a 100 percent fiber network, while recovering loop conditioning and other nonrecurring charges that reflect the higher costs of operating the existing copper-intensive network. Competitive markets would never allow a firm to engage in such double-dipping, and neither should the Commission.

In conclusion, the "most economically appropriate" interpretation of TELRIC, *Verizon Letter* at 5, is the one that the Supreme Court upheld. "Clarifying" or "altering" the Commission's TELRIC standards as proposed by Verizon would effectively abandon the Commission's hard-won victory, to the detriment of competition and consumers alike. As the Supreme Court recognized, the *existing* cost of capital and depreciation components of TELRIC are sufficiently flexible to address all relevant risks and costs, and that is true regardless of narrowband or broadband labels. And, the *Verizon Letter*, in finally recognizing that efficient investment incentives will follow from proper application of the Commission's pricing rules, gives the lie to the Bells' refrain that investment will flow only from complete deregulation without regard to competitive consequences – and hence to the entire underpinning of the Bell's UNE and broadband agendas.